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Safe Harbour Regimes in Transfer Pricing: An African Perspective

Summary of ICTD Working Paper 100 by Alexander Ezenagu

The global consensus to treat multinational enterprises (MNEs) as separate entities for tax purposes requires them to act at arm's length in the transfer of goods and services, especially setting the prices of such transfers. This means that, although in practice they are integrated entities under the ownership and control of a parent company, operating through a central management and vertical organisational structure, they must produce accounts in each country based on the fiction that they transact as independent entities would when transferring goods and services between associated enterprises. This arm's length standard was established over eight decades ago and embodied in article 9 of the model tax treaties. It remains the global standard for the treatment of MNEs.

To achieve the arm's length treatment of MNEs, five methods have been approved by supranational bodies such as the OECD and the UN to guide tax authorities in arriving at a price for the transfer of goods and services, that would be deemed to be arm's length. For all five methods, the taxpayer must include comparables in justifying the arm's length standard, that is, that the price fixed, or the profit declared is the same as would be achieved by unrelated parties dealing with each other under similar conditions and terms. Comparability is fundamental to the application of the arm's length principle since the application of the arm's length standard is based on the comparison of the conditions in the controlled transaction with the conditions in comparable uncontrolled transactions.

As has come to be globally recognised, the implementation of the arm's length standard and application of the transfer pricing methods are limited by the absence of reliable comparables to benchmark prices and terms fixed by related entities in their transactions. Also, there is the issue of capacity amongst tax authorities, coupled with the resource-intensive, time-consuming and complex nature of the process.

To ameliorate the limitations of the transfer pricing methodologies, some jurisdictions adopt simplified measures, which though diverging from the five approved OECD methods, arguably achieve a price which supposedly independent entities may have arrived at. A safe harbor regime is one such measure. The OECD Transfer Pricing Guidelines (TPGs) define safe harbours as a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. This brief explores the adoption and application of safe harbours by African tax jurisdictions.

Pros and cons of safe harbour regimes

The 2017 OECD TPGs recommend the use of safe harbour regimes to avoid the difficulties of applying the arm's length principle, by creating a regime where eligible taxpayers may elect to follow simplified transfer pricing rules or are exempt from the application of transfer pricing rules.[1]

The 2017 TPGs lists the benefits of safe harbours to include: compliance relief; tax certainty; and administrative simplicity. On tax certainty, safe harbours guarantee the acceptance of returns filed by taxpayers where the returns are within the prescribed margins or the taxpayer applies the recommended transfer pricing methods. This guarantee of

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[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2017, Ch. 4, para. 4.101, p. 205.

acceptance reduces the compliance burden on taxpayers, relieving them from potential further audits and reassessment of their tax returns. For the tax authority, the cost and the burden of administration of the tax system are reduced, encouraging voluntary compliance by the taxpayer, which is less problematic and uncertain than compliance with the full transfer pricing process. Other benefits of a safe harbor regime are reduction in the need to find data on comparables and the requirement to perform a benchmarking study in every case.

There are potential dangers of a safe harbor regime. First, a safe harbor regime may not comply with the arm's length standard. The central reason for this is that where the safe harbour prescribes a transfer pricing method to be used by a specified group of taxpayers, it may fail to consider the unique facts and circumstances of each of the taxpayers covered. As such, the prescribed transfer pricing method may not be appropriate for all taxpayers. Second, a safe harbour regime may cause double taxation. This is especially the case where a tax jurisdiction unilaterally implements a safe harbour regime. Unilateral safe harbours are problematic because countries are not bound to accept tax returns made by a related entity to a different tax jurisdiction or the transfer pricing adjustment made by such other tax authority. In the absence of corresponding adjustment, the potential for double taxation is present. Other potential dangers of a safe harbour regime include, creation of avenues for tax planning, and equity and uniformity issues as a result of a distinct set of rules created by the safe harbour regime.

Types of safe harbours

Safe harbours are commonly applied to small and medium enterprises (SMEs) and small transactions. They may exempt eligible taxpayers from applying transfer pricing rules to transactions with related entities or exempt eligible taxpayers from preparing transfer pricing documentation. These taxpayers and transactions are viewed as carrying low tax risk and do not contribute significantly to the revenue collection of these tax jurisdictions, though they cause significant compliance and enforcement burdens on taxpayers and tax authorities, respectively.

For rich countries, reduction in compliance, and enforcement costs and burden guide the introduction of safe harbour regimes in their tax jurisdictions. For African countries, increasing and guaranteeing corporate income tax collection is equally important. This additional policy objective informs the recommendation for safe harbours to be applied to high value-adding industries and large taxpayers by African tax jurisdictions. Also, it is the case in Africa (as elsewhere) that most SMEs do not come under the transfer pricing rules and practices of countries. The transfer pricing rules apply only to companies which are part of an MNE group and are involved in cross-border transactions with affiliates. Most SMEs in Africa are not affiliates of multinational groups, neither are they engaged in cross-border intra-firm transactions, and as such are not subject to transfer pricing rules and practices of the tax jurisdictions. This explains why in some tax jurisdictions the transfer pricing unit or international tax department is located under the Large Taxpayers Office.

Effective design of safe harbour regimes

African tax authorities desirous of adopting safe harbour regimes must strive to achieve safe harbour price range or rates that approximate to the arm's length price that would be achieved using the transfer pricing methods. They must be aware of the potential tax-planning opportunities from the application of safe harbour regimes. Also, given the potential discrimination against other sectors or taxpayers, safe harbour regimes must be justifiable for selected sectors.

In addition, the potential for double taxation must be addressed when establishing a safe harbour regime. While bilateral and multilateral safe harbour regimes are recommended, a carefully designed unilateral safe harbour regime may achieve the benefits of safe harbours without causing double taxation.

Furthermore, given the revenue demands of African countries and the paucity of comparables for benchmarking purpose, it is recommended that safe harbour regimes be introduced to high value-adding sectors of the economy and to large taxpayers. This also justifies the political will needed to negotiate bilateral or multilateral safe harbour regimes.

Further reading

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Credits

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